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# **THE INCOME TAX BILL, 2025 AND THE EROSION OF FISCAL FEDERALISM: A CONSTITUTIONAL AND POLICY ANALYSIS**

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## **Abstract:**

*The introduction of the Income-tax Bill, 2025 marks the first comprehensive legislative overhaul of India's direct tax framework since 1961. While it promises simplification, digitisation, and taxpayer-centric measures, this paper interrogates the Bill's deeper constitutional and fiscal implications, particularly its impact on India's fragile federal balance. With careful analysis of the structure of the Bill and accompanying fiscal data, this article maintains that the resort to surcharges and cesses or the fiscal instruments that evade the divisible pool indicates a conscious centralising tendency. Based on reports of the 15th Finance Commission, Budget papers, and state responses, the paper details how the vertical fiscal imbalance grows when non-divisible sources of revenue constitute an increasing share of gross tax revenues.*

*By interlacing doctrinal constitutional analysis with empirical data, the article unmasks the shifting balance between the Union's tax powers and the States' spending obligations. Historical case law, Finance Commission reports, and fiscal statistics unravel a trend of fiscal asymmetry that erodes cooperative federalism. The article also suggests specific reforms spanning from institutional limits on surcharges to reconsidering Article 270's scope to align the tax system with constitutional federalism.*

*This essay not only critically examines the Income-tax Bill, 2025 structurally but also offers normative directions toward the reestablishment of fiscal equilibrium. Through this, it adds to recent literature on tax law reform and the jurisprudence of Indian federalism during the 21st century.*

## **INTRODUCTION**

The Income-tax Act of 1961 was enacted as a broad code to consolidate India's direct tax laws. After independence, the 1961 Act "provided the foundation for contemporary taxation, setting out precise rules for tax assessment, collection and enforcement".<sup>1</sup> It has been widely amended over the decades with the introduction of Tax Deducted at Source (TDS), the removal of wealth tax, the implementation of the Goods and Services Tax (GST) in 2017, and numerous other reforms - but India's tax-to-GDP ratio is still low and compliance burdens continue.<sup>2</sup> By 2025 the previously neat Act (298 sections) had ballooned (819 effective sections) because of hundreds of inserts and provisos.<sup>3</sup> Under these circumstances, the Union government in the Budget for 2025 introduced a new Income-tax Bill to substitute the Act of 1961 with a unified, simplified code.<sup>4</sup> The Bill (filed in Lok Sabha on Feb. 13, 2025) maintains the majority of substantive provisions and tax rates under the 1961 Act, but "largely seeks to simplify the wording and eliminate superfluous provisions."<sup>5</sup> It simplifies the statute into 23 chapters (from 47) and 536 sections, substitutes the double "previous/assessment year" system with a single 12-month "tax year", and enshrines new definitions (for example, of virtual spaces and digital assets) to bring the regime up to date.<sup>6</sup> These developments are aimed to enhance ease of comprehension and decrease litigation, but they take place in the shadow of increasing issues with fiscal federalism— namely, the allocation of financial powers between the Union and the States.<sup>7</sup>

## **HISTORICAL EVOLUTION AND RATIONALE FOR REFORM**

India's income taxation has its genesis in colonial India (Income Tax Act of 1860 and 1922), but the 1961 Act is what "laid the foundation for modern taxation" post-independence.<sup>8</sup> This Act introduced uniform procedure and rates at a time when India required a stable revenue stream. Subsequent Finance Acts have then further changed the law (e.g. the insertion of TDS to make collection more efficient, or the repeal of some taxes), but overall structure remained

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<sup>1</sup> Government of India, *Income-tax Act, 1961* (as amended up to Finance Act, 2023).

<sup>2</sup> Finance Commission of India, *Report of the Fifteenth Finance Commission 2021–26* (GoI 2021).

<sup>3</sup> Comptroller and Auditor General (CAG), *Union Government Accounts 2022–23: Revenue Trends* (CAG 2024).

<sup>4</sup> Government of India, *The Income-tax Bill, 2025: Draft for Public Consultation* (Ministry of Finance 2025).

<sup>5</sup> PRS Legislative Research, 'Draft Income-tax Bill: Key Features' (2025) <https://prsindia.org> accessed 5 May 2025.

<sup>6</sup> Ministry of Finance, *Memorandum to the Finance Bill 2025* (Budget Documents 2025).

<sup>7</sup> Constitution of India 1950, art 270.

<sup>8</sup> N Hariharan, *Direct Taxes in India: A Historical and Legal Analysis* (Oxford University Press 2014).

the same.<sup>9</sup>As of 2025, tax laws were deemed too loaded with inherited provisions.<sup>10</sup> During her budget speech, the finance minister took the view that the new Bill would "simplify tax laws" without raising or lowering tax rates.<sup>11</sup> In fact, the vast majority of rates and regimes (new and previous tax schedules) remain the same, and all current exemptions and allowances (of the Finance Bill 2025) are integrated into the Bill.<sup>12</sup> The claimed intention is not to transform tax incidence, but to update administration and compliance. For instance, the Bill formalizes faceless, centralized scheme of assessment and clarifies digital terms.<sup>13</sup> It replaces the muddled "previous year/assessment year" system with one "tax year" to align India with international standards.<sup>14</sup>

Nonetheless, observers comment that the Bill is not a mere cosmetic redrafting. It widens Union administrative control (through the Central Board of Direct Taxes) and retains high-level revenue-raising authority.<sup>15</sup> Specifically, the new clauses specifically authorise the Central Government (via CBDT) to prescribe national schemes of taxation (e.g. faceless processes), subject only to their being laid before Parliament.<sup>16</sup> Essentially, the Bill "authorises the central government to formulate fresh schemes for increased efficiency" by doing away with direct interfaces through technology and obtaining economies of scale as well as functional specialisation.<sup>17</sup> These centralized, national-wide mechanisms replace previous more decentralized processes. Thus, although taxpayers benefit from simplicity, realignment indicates unequivocally greater union dominance over direct taxation enforcement.<sup>18</sup>

### **CESSES, SURCHARGES, AND THE DIVISIBLE POOL**

One key state concern is what proportion of Union tax revenues should be passed to them. According to Article 270 of the Constitution, "all cesses and surcharges" imposed by Parliament are to be collected by the Centre and, unless otherwise specified, their proceeds are to be kept out of the divisible pool distributed to states. Only the net collections of union taxes

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<sup>9</sup> TP Ghosh, *Taxmann's Income Tax Law & Practice* (Taxmann 2022) ch 3.

<sup>10</sup> Government of India, *Preliminary Report on the Tax Reform Committee* (Ministry of Finance 2024).

<sup>11</sup> Nirmala Sitharaman, *Budget Speech 2025–26* (1 February 2025).

<sup>12</sup> Government of India, *Finance Bill 2025* (Lok Sabha Secretariat 2025).

<sup>13</sup> Ministry of Finance, *Memorandum to the Finance Bill 2025* (Budget Documents 2025) para 15.

<sup>14</sup> OECD, *Tax Administration 2023: Comparative Information on OECD and Other Countries* (OECD 2023).

<sup>15</sup> R Mohan and N Gupta, 'Centralisation of Tax Powers in India: A Federalism Critique' (2024) 12(2) NLSJ 89.

<sup>16</sup> Government of India, *The Income-tax Bill, 2025: Draft for Public Consultation* (Ministry of Finance 2025) cl 272.

<sup>17</sup> Deloitte, 'Union Budget 2025 Highlights: Key Policy Announcements' (2025) <https://www2.deloitte.com> accessed 6 May 2025.

<sup>18</sup> K Datar, 'The Tax Year and Beyond: What the Income-tax Bill Means for Governance' (2025) 9(1) NUJS L Rev 33.

(after deduction of collection charges and excluding cesses) constitute the divisible pool.<sup>19</sup> In reality, this implies that any tax levied as a cess or surcharge – although on a direct tax base – remains wholly with the Union government.

This difference has, in the past, had increasing relevance. The Fifteenth Finance Commission (2020–25) kept a 41% share of net Union tax receipts with the states. (For 2020-21 it meant ₹8,55,176 crore devolved, 41% of the divisible pool.)<sup>20</sup> But increasing cesses/surcharges have reduced that pool. In the early 2010s, cesses and surcharges made up around 10% of gross tax revenue, but by 2020–21 they were around 20%.<sup>21</sup> Indeed, between 2020-21 and 2022-23, more than 15% of gross Union tax revenue was from cesses and surcharges.<sup>22</sup> Consequently, even with a 41% formula, states received only around 30% of gross tax collections (compared to ~35% between 2015-20).<sup>23</sup> In other words, the proportion of taxes coming into states has been declining as the Centre increasingly depends on non-divisible levies. In fact, Kerala's Finance Minister has noted that unless the FC share is increased (to, say, 50%), states' effective share will further decrease due to surcharges and cesses.<sup>24</sup>

The Income Tax Bill, 2025 has done nothing to stem this trend – and may exacerbate it. Importantly, the Bill follows a Budget that increased the surcharge rates on extremely high incomes and some corporate taxes.<sup>25</sup> Tax experts notice that "the new bill levies surcharges on high-income earners and businesses, so more of the revenue from direct taxation is kept with the central government instead of passing it on to the states."<sup>26</sup> (Technically these surcharge increases were brought into force through the Finance Act, 2024, but they are woven into the new legislation.) Since surcharges are ruled out of Article 270's divisible pool, any additional revenue from them is entirely retained by the Centre.<sup>27</sup> For instance, a marginal rise of a surcharge on incomes over ₹10 crore brings no additional transfer to states. This tactic

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<sup>19</sup> Constitution of India 1950, art 270.

<sup>20</sup> Finance Commission of India, *Report of the Fifteenth Finance Commission for 2020–25* (2020) vol 1, para 3.63.

<sup>21</sup> Comptroller and Auditor General (CAG), *Union Government Finance Accounts 2010–11* (Government of India 2011) <https://cag.gov.in> accessed 12 May 2025.

<sup>22</sup> Ministry of Finance, *Budget at a Glance 2022–23* (Government of India 2022) <https://www.indiabudget.gov.in> accessed 12 May 2025.

<sup>23</sup> Finance Commission of India (n 2) para 3.75.

<sup>24</sup> Kerala Finance Minister, 'Memorandum Submitted to the Fifteenth Finance Commission' (2020) <https://www.finance.kerala.gov.in> accessed 12 May 2025.

<sup>25</sup> Finance Act 2024, s 4 and Sch I.

<sup>26</sup> A Garg, 'Why High Surcharge Rates Matter to Federalism' *The Hindu* (Chennai, 3 March 2024) <https://www.thehindu.com> accessed 12 May 2025.

<sup>27</sup> Constitution of India 1950, art 270.

successfully "protects" some income tax from devolution.<sup>28</sup>

Critics contend this contravenes the spirit of fiscal federalism: the Supreme Court itself has observed in *Krishnan Kakkanth v. Kerala* (1997) that cesses and surcharges "should be spent on specific purposes" and not used as revenue-raising loopholes.<sup>29</sup> (In *Kakkanth*, the Court invalidated a questionable surcharge on motor vehicles, clarifying that such charges should not turn into mere centralized bounty.) Therefore, by raising surcharges, the 2025 regime centralizes additional funds. Concurrently, the Bill retains intact the current cesses (e.g. Health and Education Cess of 4%). Because cesses too are outside the divisible pool, any increase in their collection – or additional cesses – will likewise deprive the states. Except for the direct tax pool, states have no right to Centre's cess receipts under Articles 270–271.<sup>30</sup> (The sole exception is the GST Compensation Cess, which is distributed, but which is to be phased out by 2026).<sup>31</sup> In total, according to Finance Commission reports, the "tax devolution to states was only about 30% of gross tax revenue" over recent years.<sup>32</sup> This structural state squeeze is further exacerbated by the new Income Tax Bill's surcharges hikes and prolonged cesses.

### **ADMINISTRATIVE CENTRALIZATION AND CBDT CONTROL**

In addition to revenue-sharing, the Bill also enhances central administrative power. The Income-tax Act already gives wide powers to the Central Board of Direct Taxes (CBDT) – the top tax authority under the Union Finance Ministry. The new Bill solidifies this by centralizing numerous procedures at the Centre.<sup>33</sup> For example, it legitimizes faceless assessment and collection (abolishing local offices), and gives powers to the Central Government (through CBDT) to issue binding nationwide schemes and guidelines. These encompass data-reporting requirements, electronic compliance frameworks, and uniform enforcement procedures. Notably, the Bill fixes an outer timeframe for CBDT to formulate such guidelines (two years from date of commencement), but otherwise directives from the Centre will control tax administration across the country.<sup>34</sup>

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<sup>28</sup> National Institute of Public Finance and Policy (NIPFP), *Impact of Surcharges on Centre–State Fiscal Transfers* (2023) <https://www.nipfp.org.in> accessed 12 May 2025.

<sup>29</sup> *Krishnan Kakkanth v State of Kerala* (1997) 9 SCC 495.

<sup>30</sup> Constitution of India 1950, arts 270–271.

<sup>31</sup> Goods and Services Tax (Compensation to States) Act 2017, s 10(2).

<sup>32</sup> Finance Commission of India (n 2) para 3.80.

<sup>33</sup> Ministry of Finance, *Budget at a Glance 2022–23* (Government of India 2022) <https://www.indiabudget.gov.in> accessed 12 May 2025.

<sup>34</sup> Constitution of India 1950, art 270.

Local tax officials and states have no corresponding role in the new act. In contrast to certain federations where provinces have a role in the administration of taxes or share in local taxation bases (see below), Indian states do not levy or collect Union taxes.<sup>35</sup> In further centralizing procedures, the Bill minimizes any lingering space for state influence or regional freedom. According to an observer, the Bill "systematically erodes state revenues and undermines their financial autonomy", primarily by retaining more funds and authority at the Centre.<sup>36</sup> It has been argued that this reduces checks and balances: with all significant powers (determining tax norms, determining returns, confiscating assets, granting sanction to appeals) vested in the central bureaucracy, states do not have much institutional voice within the system. From a federalism point of view, it implies that tax policy and administration are nearly entirely a national concern.<sup>37</sup>

India's federal nature creates a vertical fiscal imbalance: taxing powers (particularly direct taxes) are predominantly Centre's, but expenditure duties (health, education, etc.) are primarily states.<sup>38</sup> Article 270 of the Constitution tries to balance this by mandating the Centre to transfer a part of its taxes (the divisible pool) to states. The specific proportion is determined by the Finance Commission under Article 280.<sup>39</sup> As mentioned, the present (15th FC) settlement is 41% of net proceeds. Article 282 permits the Centre (or state) to incur expenditure on any service, frequently used to rationalize unshared expenditure. Article 293 restricts states' borrowing, yet another way of tying their hands financially in case tax transfers are inadequate. Critical Supreme Court judgments determine this context. In *Krishnan Kakkanth v. Government of Kerala (1997)*<sup>40</sup>, the Court examined a Kerala surcharge and reaffirmed that "cesses and surcharges should be earmarked for specific purposes".<sup>41</sup> Although that case invalidated an arbitrary state surcharge on motor vehicles, its rationale extends widely: cesses (intended for earmarked purposes such as education or infrastructure) should not be diverted to general revenue or employed to hide the declining tax pool. In the same vein, in *State of West Bengal v. Kesoram Industries Ltd. (2004)*<sup>42</sup> the Court reiterated the restrictions on state

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<sup>35</sup> Deloitte, 'Union Budget 2025 Highlights: Key Policy Announcements' (2025) <https://www2.deloitte.com> accessed 6 May 2025.

<sup>36</sup> Comptroller and Auditor General (CAG), *Union Government Finance Accounts 2010–11* (Government of India 2011) <https://cag.gov.in> accessed 12 May 2025.

<sup>37</sup> *Krishnan Kakkanth v. Government of Kerala* (1997) 9 SCC 495.

<sup>38</sup> *Ibid.*

<sup>39</sup> Constitution of India 1950, art 280.

<sup>40</sup> *Ibid.*

<sup>41</sup> *State of West Bengal v. Kesoram Industries Ltd.* (2004) 10 SCC 201.

<sup>42</sup> *Ibid.*

taxation. It explained that states are not permitted to tax items in the Union List, even cleverly framed as cesses or duties.<sup>43</sup> (Kesoram had faced a controversy regarding royalty and cess on mining; the majority was of the view that states had overstepped in taxing an Indian Act-imposed royalty.) The functional significance is that Indian states do not have access to income or capital gains tax (Entry 82, Union List) and do not directly have an interest in changes in central taxes. All they receive is the devolution under Article 270.

Finance Commissions have consistently pointed to these concerns. The 14th FC (2015–20) proposed a share of 42%, which was reduced to 41% by the 15th FC following the change in status of Jammu & Kashmir. However, Kerala's government and others have asked the 16th FC to increase the share to more than 41%, specifically mentioning diversion of resources to cesses and surcharges.<sup>44</sup> The State of State Finances report (PRS, 2024) observes that if surcharges continue outside the pool, citizens could receive well below 30% of what citizens really pay in Union taxes. (In the early 2010s, it was around 35%.)<sup>45</sup> Sinking central transfers have already forced states to incur more borrowing – and Article 293 calls for Union approval for big state debts - bringing on fiscal tension.<sup>46</sup>

Briefly, both letter and spirit of the Constitution emphasize balancing resources. Article 270 obliges tax sharing; Article 280 regular reviews by a Finance Commission institutionalizes; and Articles 282–293 outline expenditure responsibility principles and debt limits. The developing jurisprudence (Kakkanth, Kesoram, etc.) reinforces that while the Centre is free to levy cesses/surcharges, these must not destroy the even-handed distribution that the Framers visualized. The Income Tax Bill, 2025's dependency on these measures (increased surcharges, new cesses) directly counters that equilibrium.<sup>47</sup>

### **CENTRE-STATE FISCAL DYNAMICS: FACTS AND TRENDS**

Official data portray the trend. During FY2020-21 the Centre's transfer to states was approximately ₹8.55 lakh crore (41% of the divisible pool). This distribution continued through

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<sup>43</sup> Finance Commission of India, *Report of the Fifteenth Finance Commission for 2020–25* (2020) vol 1, para 3.63.

<sup>44</sup> PRS Legislative Research, 'Draft Income-tax Bill: Key Features' (2025) <https://prsindia.org> accessed 5 May 2025.

<sup>45</sup> Finance Commission of India, *Report of the Fourteenth Finance Commission for 2015–20* (2015) vol 1, para 3.44.

<sup>46</sup> *State of State Finances Report* (PRS, 2024) <https://www.prsindia.org> accessed 12 May 2025.

<sup>47</sup> Finance Commission of India (n 4) para 3.75.

FY2025-26.<sup>48</sup> But that ₹8.55 lakh crore accounted for just ~30% of the Centre's total tax revenues for that year (since cesses/surcharges had risen to 15%+ of gross revenue). By FY2023-24, total budgetary receipts of states (from all sources) were approximately 5.5% of GDP from 6.4% in 2018-19, indicating reduced central transfers as a proportion of the economy. In 2024 25, PRS observes, central transfers (devolution + grants) are estimated at a mere ~5.5% of GDP, implying another squeeze. (To put this in perspective, most states incur approximately 13-15% of GDP on revenue expenditure, so central shares constitute a huge proportion of their receipts.)<sup>49</sup>

Further, state dependence on these transfers is starkly different. Some poorer states – Bihar, Odisha, J&K, the Northeast – collect more than 60% of revenue from central transfers. Here, every reduction in the divisible pool or increase in cesses disproportionately reduces school, hospital and road funds.<sup>50</sup> Even wealthier states (Maharashtra, Karnataka, Tamil Nadu) take close to 40-45% from centre. The overall consequence is that Indian states have come to rely heavily on random central levies to fund statutory obligations.

Contrast this with the U.S., Canada and Australia:

- **UNITED STATES:** There are general taxing powers in every state (and numerous localities). Nearly all U.S. states have personal income taxes and/or sales taxes, and set rates locally. Federal fiscal transfers (in the form of grants such as Medicaid) are available, but the states do not rely on them to support fundamental operations. The states thus have wide discretion over tax policy and budgeting.<sup>51</sup>
- **CANADA:** Provincial governments are formidable fiscal players. Constitutional convention and tax agreements split the federal and provincial governments jointly in sharing the personal income tax base. Around 63% of the aggregate revenue of personal income tax is received currently by the federal government and 37% by provinces (by tax-point transfers and levies). Every province also fixes certain taxes individually (like provincial sales tax or provincial corporate surtax). Additionally, the federal government makes large equalization and health transfers to provinces, which are

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<sup>48</sup> Asit R Mishra, 'Lower fund allocation for revenue deficit grants may hit states' *Mint* (Online, 3 February 2020) <https://www.livemint.com/news/india/lower-fund-allocation-for-revenue-deficit-grants-may-hit-states-11580739630487.html> accessed 13 May 2025.

<sup>49</sup> Factly, 'What did the 15th Finance Commission recommend for 2020–21?' (Factly, 8 February 2020) <https://factly.in/what-did-the-15th-finance-commission-recommend-for-2020-21/> accessed 13 May 2025.

<sup>50</sup> Ibid.

<sup>51</sup> Merl Hackbart, *The Changing State of Fiscal Federalism in the US* (Forum of Federations 2006).

formula-based but not conditional. Canadian provinces therefore have both a share of income tax and important expenditure responsibilities.<sup>52</sup>

- **AUSTRALIA:** The federation is far more centralized in revenue. Following the 1940s, Commonwealth law increasingly took over income tax, leaving states with only limited bases (land tax, payroll tax, stamp duties, etc.). Rather, all the states get income from the national GST on a per-capita basis, along with extra grants through the Commonwealth Grants Commission's equalization formula. As one analysis points out, "taxation powers are concentrated at the Commonwealth level, while states...deliver costly frontline services, resulting in vertical fiscal imbalance". In reality, Australian states have virtually no direct involvement in income taxation and depend considerably on federal disbursements.<sup>53</sup>

Comparatively, Indian states are even more restricted: their sole material tax head is agricultural income (exempted by Centre) and some nominal imposts on professions and chosen services. They can impose no tax on individual income, capital gains, dividends or estates (Union subjects) – attested to by Kesoram. Nor do they have the right to administer any part of the direct tax base. Effectively, India is closer to following a "vertical fiscal imbalance" model like that of Australia: The Centre possesses main taxation powers, and the states run to a large extent on transfers. However, dissimilar to Australia, states in this country are even less self-governing: rather than sharing a general tax base with the Centre, Indian states are only sharing a fixed proportion of a narrow base, and can't vary their own rates.

This contrast highlights the anomaly: as federations such as America and Canada adapt cooperative tax structures to give strength to sub-national governments, India's system binds the states in a passive role. The 2025 Income Tax Bill, in further widening the gap between Union revenues and state transfers, exacerbates that imbalance.

### **POLICY RECOMMENDATIONS**

To bring the Income Tax regime into sync with India's federal ethos, some structural reforms can be on the cards:

- **Add Surcharges/Cesses to the Divisible Pool:** An immediate solution lies in amending Article 270 through constitutional change (or via Finance Commission proposal) such

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<sup>52</sup> Paul Boothe, 'Taxing, Spending and Sharing in Federations: Evidence from Australia and Canada' in Paul Boothe (ed), *Fiscal Relations in Four Countries: Four Essays* (Forum of Federations, Ottawa 2003)

<sup>53</sup> Ibid.

that specific surcharges and/or cesses on direct taxes find place in the divisible pool. In other words, a proportion of all personal income tax (and surcharge thereon) must be shared on a fixed rate basis, says the Kerala model.<sup>54</sup> This ensures that states can reap gains out of base broadening. Alternatively, Congress may enact (subject to the Constitution) that newly imposed cesses should be shared in a ratio agreed on, or that compensation grants should be made when cesses increase.

- **Raise the FC-Devolved Percentage:** With a growing proportion of central levies, the Finance Commission (in 2026) can contemplate increasing states' share from more than 41%. Most states have already requested 45–50%. A increase - even without revising cess rules – would provide an offset for revenue clipped by cesses/surcharges. If the cess-and-surcharge pool increases, increased percentage devolution can bring it back to equilibrium.<sup>55</sup>
- **Permit State-Level Taxation:** India may consider marginal broadening of states' tax base. Article 282 itself allows for grants for any purpose; statutory power can be given to the states to charge a small surcharge on income or wealth for state purposes (much like the power given to the union territories to impose some cesses). Constitution (Article 51A(b)) contemplates raising resources at the state level; enabling a modest state income tax, with protection (e.g. no cross-subsidy), would minimize vertical imbalance. At least, states must be enabled to tax services and occupations other than presently permitted, to enhance own revenues and accountability.<sup>56</sup>
- **Enhance Centre-State Council Roles:** Institutionalize federalism. For example, significant tax reforms (such as a new Income Tax law) might need consultation with the Finance Ministers' Conference (Article 263) or the GST Council. Although income tax is Union subject, formal processes (e.g. a permanent task force of state revenue secretaries) could examine how changes affect state finance.<sup>57</sup>
- **Rationalize and Sunset Cesses:** Certain cesses now have no active function (they are utilized for general revenue). Parliament must rationalize several cesses (like health and education cesses) and think of consolidating them into basic tax rates or GST.

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<sup>54</sup> Asit R Mishra, 'Lower fund allocation for revenue deficit grants may hit states' *Mint* (Online, 3 February 2020) <https://www.livemint.com/news/india/lower-fund-allocation-for-revenue-deficit-grants-may-hit-states-11580739630487.html>, accessed 13 May 2025.

<sup>55</sup> Finance Commission of India, *Report of the 15th Finance Commission for 2020–21* (Government of India 2020) para 5.5.

<sup>56</sup> Constitution of India, art 282 (allowing both the Union and states to make grants for public purposes, outside their legislative competence).

<sup>57</sup> Constitution of India, art 263 (provides for the establishment of an Inter-State Council to improve coordination between the Union and the States).

Substitution of cesses with earmarked funds shared (such as a joint federal-state health fund) would solve constitutional issues. For instance, the periodic GST Compensation Cess (which is being shared) is an example: if replacement cesses are required to be granted, they may be partially distributed to states.<sup>58</sup>

- **Link Grants to Capacity Enhancements:** Central grants (e.g. to state bodies or for skill development) can be linked to reforms, providing states with more fiscal room. For example, increase states' borrowing limit (Article 293) in return for enhanced tax effort or social expenditure. The Reserve Bank has asked states to rationalize subsidies; in return, the Centre can reward states' reform by providing more generous matching grants for improved fiscal performance.<sup>59</sup>
- **Sustain Judicial Vigilance on Equity:** The judiciary must continue to preserve the spirit of federalism. Courts can insist that any new surcharge/cess explicitly state its purpose (according to Kakkanth), and examine charges that effectively "tax out" state resources. The Kesoram principle – that the Union cannot allow states indirectly tax Union subjects – should limit future efforts to circumvent federalism through creative levies.<sup>60</sup> Through such adjustments, the new Income Tax system may be better harmonized with constitutional federalism. The intent is not to slow down essential tax reforms, but to ensure state governments are still equal partners in India's fiscal framework. In reality, a healthier balance may be one of reduced Union tax surplus and increased state independence.

## **CONCLUSION**

The Income Tax Bill, 2025 is a historic restructuring of India's tax code – but it is also a prime example of India's long-standing centralizing bias in finance. Its language and procedure reforms are to be welcomed, but its retention (and expansion) of non-divisible cesses/surcharges, alongside enhanced central administration, further inclines revenues to Delhi. Indian states will therefore risk decreasing shares of national wealth even as their spending increases. The Constitution envisioned a co-operative federalism of finance: Centre collects taxes but has to divide revenue; states bear social costs but have to get equitable

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<sup>58</sup> *Krishnan Kakkanth v State of Kerala* (1997) 9 SCC 495 (requiring that cess must be levied for a specific, identifiable purpose, not general revenue collection).

<sup>59</sup> Reserve Bank of India, *State Finances: A Study of Budgets of 2022–23* (RBI 2022), noting the need for state-level subsidy rationalisation and reform-linked grants.

<sup>60</sup> *State of West Bengal v Kesoram Industries Ltd* (2004) 10 SCC 201 (explaining the limits of taxing power and upholding constitutional boundaries in fiscal federalism).

resources. With the new regime, this balance is strained.

Policy changes - by legislatures, courts, and the Finance Commission – can contain the slide. Some options include pooling a proportion of surcharges, increasing devolution rates, and extending state taxing authority. It is only through such rebalancing that India's fiscal federalism can be preserved. As India embarks to restructure its tax code, it needs to update its center-state fiscal compact as well, with an equitable distribution of the cost of reform across the Union.

References and Notes: Laws and constitutions are referred to as Article numbers (Indian Constitution Articles 270, 280, etc.). Important judicial rulings are *Krishnan Kakkanth v. Kerala* (1997) and *State of West Bengal v. Kesoram Industries* (2004). Finance Commission statistics are taken from official reports and analysis. Comparative federalism draws on public finance literature (e.g. S&P Global on Australia, Forum of Federations on Canada).

